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ABSTRACT

Designed to help college administrators read and understand accounting statements, this paper provides tips about danger signals that may be evident in financial statements and that may call for speedy action. The first statement examined is a balance sheet; i.e., a summation of all of the possessions and debts of a business or entity, which shows the equity or ownership interest as the differences between the possessions and debts. After commenting on the importance of periodically creating and comparing balance sheets, the paper examines a balance sheet for a hypothetical college food service unit line by line. Comments are made on areas needing special attention, including, in relation to assets, cash account, petty cash, investments, accounts receivable, inventory, total current assets, fixed assets, equipment and fixtures, depreciation allowance, and total assets; and, with respect to liabilities, accounts payable, accrued liabilities, total current liability, fund balance, and total liabilities/net worth. The next section of the paper examines the income statement of a hypothetical college bookstore, pointing to areas indicating whether the bookstore is profitable or being subsidized, and whether it is efficient and protected by proper accounting controls. This section examines sales revenue and expenses and problems revealed in the statement. (HB)

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KNOW YOUR BOTTOM LINE:
THE CONTROL OF YOUR AUXILIARIES

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KNOW YOUR BOTTOM LINE

The Control Of Your Auxiliaries

Accounting statements are dull reading material. They never make the best seller list. Hardly anyone ever studies them. Even fewer people understand them and learn the secrets they contain and can reveal. If you are part of the overwhelming majority who think accounting statements are dull and incomprehensible, this is for you. If you did not feel the need and the desire to understand financial statements and what they tell about your auxiliaries, I'd have lost you before this point.

Perhaps you have tried to become more knowledgeable about accounting and still find it a mystery. I'm not suprised. While preparing this paper, I reviewed some of the texts that I have used to teach accounting. I saw that we teach students to prepare statements, not to read and interpret them. There are few materials available that are instructive in the art of analysis and interpretation of financial statements. One very good reference is "How To Read A Financial Report" by John A. Tracy, published by John Wiley and Sons.

If you are still with me, let's explore together the secrets inside accounting statements. We'll skip over the dullest types of statements - those with no scandals to report, problems to correct, or people to watch.

The statements that we shall look at all have danger signals; and we shall learn to recognize them, and learn what steps you can take to control the situation and make corrections, if needed.

The first statement we shall study is the balance sheet. The balance sheet is a summation of all of the possessions and all of the debts of a business or entity. It shows the equity or ownership interest as the difference between the possessions and the debts. The summation reflects one single moment in time. By the time a 2000 line per minute printer can produce a balance sheet, time and the entity have moved forward, and the figures in the summation have probably changed.

It is important to make these periodic summaries and compare them with summaries from earlier dates to see what improvement is evident or what deterioration is happening.

It is best to have data from two or more prior periods to compare, but, in the interest of brevity and clarity, I'll limit my comparisons to two fiscal years.

CRISIS COLLEGE
FOOD SERVICE UNITS
BALANCE SHEET
DECEMBER 31, 1982 and December 31, 1983

	12/31/83	12/31/82
Assets		
Current Assets		
Cash	$ 5,714.00	$ 7,826.00
Petty Cash	350.00	250.00
Investments	-0-	30,000.00
Accounts Receivable	5,756.00	2,554.00
Inventory	28,374.00	19,717.00
Prepaid Items	1,019.00	1,774.00
Total Current Assets	$ 41,213.00	$ 62,121.00
Fixed Assets		
Equipment/Fixtures (Cost)	$195,000.00	$195,000.00
Less Allowance For Dep.	96,000.00	85,000.00
Total Fixed Assets	99,000.00	110,000.00
Total Assets	$140,213.00	$172,121.00
Liabilities/Net Worth		
Current Liabilities		
Accounts Payable	$ 48,210.00	$ 32,600.00
Accured Liabilities	2,400.00	2,100.00
Due to Other Funds	7,000.00	5,000.00
Total Current Liability	57,610.00	39,700.00
Fund Balance (Net Worth)	82,603.00	132,421.00
Total Liabilities/Net Worth	$140,213.00	$172,121.00

This college food service has all kinds of trouble. Even a very naive and untrained eye can spot the one-third decline in fund balance, or net worth, and know that this is an auxiliary in trouble. In a case this obvious, the preparer of the statement, or an internal or external auditor, would have included with it many questions and comments about the statement and the concerns that it raises. Usually the problem areas are fewer and less obvious, and not as important to an accountant or auditor as to an auxiliary manager. It takes a sharp eye to spot trouble early, and it's a very comfortable feeling to have noticed a situation and had it explained or corrected before an auditor arrives, or before - worst of all - a disgruntled employee reports irregularities to the news media, administrators, or law enforcement officials.

If we look at each line of this statement, we can see what questions are raised and how to get to the bottom of them. The statements prepared for your campus and for other auxiliaries may, on the surface, appear quite different and may be longer and more complex. Do not let that concern you. The important accounts are included here -

the ones that reveal any secrets about the operation and whether it is financially solid or not. Because accounting terminology is generally effectively standardized, you should be able to select and intelligently review any balance sheet, including those of private concerns that you may be considering for contractor relationships or as investment possibilities.

First, the cash account by itself does not cause alarm. Cash fluctuates according to needs and timing of payroll and invoice payment. A change in the size of the cash balance is not necessarily significant. Looking at the cash balance does remind you to check to be sure that cash receipts are controlled and deposited promptly; that someone other than the cash handler reconciles the bank statement; and that your bank is giving you the best service and prices available.

Petty cash has been increased, indicating that the operation has become less formal and control conscious. Petty cash funds should be small, should be audited periodically - say quarterly at the least - and should have all disbursements evidenced by receipts.

Investments are very important. Cash is too valuable to allow it

to remain idle. Cash invested for short periods provides current return of about 9 percent. In recent years, the return was as high as 18 percent. As much idle cash as possible should be placed in short-term investments.

The cash and investments accounts are, therefore, the same dollars in different pockets. At Crisis College, the cash position is seriously impaired. There is not enough cash available to pay the bills coming due in the accounts payable account.

We immediately begin to look for a source of cash to pay bills and meet payroll. Our first stop is at the accounts receivable line. We note that receivables have increased. We ask for an analysis of the receivables. How old are they? Are they current or past due? Are they collectable or are these debts of students who have left campus and are, therefore, possibly difficult collection problems? Has an allowance been created for uncollectable accounts? Is there a regular and effective collection effort?

We look at our inventory. It has increased by 50 percent. This is a definite cause for concern. We ask how the inventory was taken.

What prices were used to value the inventory? Are the calculations and totals verified? Is the inventory good and saleable? Will the inventory be used in the near future, or is the unit overstocked? Inventory is much more important from a financial viewpoint in bookstore operations than in dining rooms because of the size of inventory needed to conduct business. Food service inventory is largely perishable and, therefore, must be kept small and properly stored.

Prepaid items are such things as licenses and insurance paid in advance and valid until a future date. A decline in the amount reported in this category leads us to ask if some payment in one of these very important areas has been neglected or held until overdue.

Our fixed asset accounts in the higher education sector usually include equipment, but not buildings or land. Land and buildings are usually "owned" by some other part of the institution; and upkeep, insurance, and mortgage payments charged to other funds, frequently without an adequate charge back or rent to the auxiliary. At this point, our doubts about Crisis College's fiscal operations are growing.

Equipment and fixtures are proper accounts and depreciation should

be recorded. We note in this example that Crisis College has apparently not acquired any new equipment or fixtures this year. This would lead us to check the condition of present equipment to see if the less than 10 percent depreciation allowance addition was adequate, and if you can expect a big demend for new equipment and fixtures soon. We do know that we do not have the answer here to the problem of the cash crisis. There is no indication that cash has been spent for equipment or fixtures.

The next line on the statement, accounts payable, presents a major problem. Suppliers must be paid or deliveries will cease. A financial analyst rating a business for credit lines or investment uses formulas known as working capital ratio and quick (or acid test) ratio.

The working capital ratio is the ratio of current assets (cash and things that convert to cash) to current liabilities. In this example, the 1982 ratio was 62,121 to 39,700, or 1.56. The ratio indicates that the entity can pay its current bills. In 1983, this working capital ratio drops to 41,213 to 57,610, or .71. There is a problem maintaining liquidity.

The quick ratio, or "acid test", omits the inventory and prepaid items from the equation. Prepaid items usually cannot be cashed in by a going concern to pay bills, and inventories may not sell or may result in more receivables rather than cash.

The Crisis College food service quick ratio of 40,630 to 39,700, or 1.0, for 1982 was very thin, and a distinct early warning of trouble coming. The 1983 quick ratio of 11,820 to 57,610, or .20, tells you that very soon suppliers may be calling about past due accounts, demanding payment on delivery, and threatening collection action.

What has happened to the food service division at poor Crisis College? It's auxiliary director had better begin to look hard at this operation. The service has obviously lost money and needs to be carefully reviewed in total.

Short of such a major crisis, the auxiliary manager needs to have, and carefully examine, a balance sheet on each enterprise. Annual statements will do unless a problem inspires a desire for more frequent reports. In the above example, the razor thin quick ratio margin should have prompted a request for interim statements in 1983, perhaps

quarterly, to avoid serious trouble.

Any of the problems noted in the Crisis balance sheet are worth detailed examination. Let's conclude the balance sheet discussion on a happy note, by assuming that Crisis College has a super food service director who serves delicious balanced meals in an efficient and hygienic operation. The problem could be simply one of an inadequate price structure - imposed, of course, by a dean or board of trustees.

Investigation of financial statements should always be begun under the classic assumption of innocence until culpability is established. Financial audits and questions are always threatening and need to be handled with great delicacy and tact. A manager should begin by quietly requesting and reviewing additional information such as bank reconciliations, analysis of receivables, inventory reports, and analysis of payables. After thorough review, with the help of auditors, if needed, appropriate action should be evident and improvement can begin.

Our second financial statement is even more important than the first. Crisis College also has a bookstore and we want to know if it is

really profitable or if it is being subsidized. We want to know if it is efficient and protected by proper accounting controls. Let's examine an income statement.

The income statement summarizes sales revenue and expenses over a period of time, for a full year in our example, compared with the prior year. All amounts included are cumulative totals for one year. The income statement is conveniently constructed to tell its story line by line as we read down.

CRISIS COLLEGE BOOKSTORE

	1983	1982
Retail Sales (Less Ret/Allow)	$1,200,000	$1,100,000
Wholesale Sales	55,000	75,000
Total Net Sales	1,255,000	1,175,000
Cost of Goods Sold		
Beginning Inventory	275,000	250,000
Net Purchases (Less Ret/Allow)	1,105,000	961,000
Freight	3,000	2,000
Total Available	1,383,000	1,213,000
Less Ending Inventory	340,000	275,000
Total Cost Of Goods Sold	1,043,000	938,000
Gross Margin On Sales	$ 212,000	$ 237,000
Operating Expenses		
Personnel Costs		
Salaries Wages	$ 141,000	$ 145,000
Benefits Taxes	20,000	20,000
	161,000	165,000
Occupancy		
Rent	25,000	25,000
Utilities Taxes Repair Insurance	10,000	10,000
	35,000	35,000
Advertising	4,000	5,000
Communications	5,000	4,000
Supplies	7,200	7,000
Furniture Fixture Depreciation	8,000	8,000
Professional Meetings Travel	500	2,000
Professional Services	-0-	2,000
Other	300	1,000
Total Operating Expenses	$ 221,000	$ 229,000
Net Operating Revenue	$ (9,000)	$ 8,000
Other Income	11,000	7,000
Net Income	$ 2,000	$ 15,000

We can see that Crisis College is an old fashioned school, conditioned to intellect and student care taking. It does not yet look to its auxiliaries for profit, and we can see a modest bottom line in the black. To be sure, some small reduction in income was noted and you have felt a little uneasy; but, you have noted that the store manager is concerned, has had difficulties with publishers and students this year, and seems to be putting in more hours to keep it together. So, do we file it away and turn our attention elsewhere?

No way! We are going to comb this statement end to end, and see what it tells us to check into.

Begin with retail sales. Does the increase match the increase in enrollment, or is it due to price increases? An increase of 9 percent in sales would be about right these days for a stable enrollment.

Wholesale sales are down - quite a bit. We want to know why? Have we lost business or was 1982 atypical? Are billings behind?

Cost of goods sold is a neat package with a story all its own,

and it is the most important story in the statement. It tells us what our gross margin on sales has been. We know what this figure should be and if it isn't - we have a problem.

We know what the gross margin should be because we have consciously adopted a pricing policy. We know how much markup has been added to cost to arrive at price and an average of this markup rate should be reflected in the ratio of gross margin to total cost of goods sold.

At conservative Crisis, we had agreed to stick with a 25 percent add on to textbook price, and then sell most supplies and essentials at the same markup price, going to a retail markup of 33 percent to 40 percent only on impulse items and items in competition with local trade. This produced a markup of just over 25 percent for 1982, a satisfactory rate with a break-even goal.

If we have not changed this decision, we should have expected a gross margin of 25.3 percent of 1983 cost of goods sold, or $263,000. Suddenly, we realize that we are not looking for a $13,000 or $17,000 reduction in net profit, but, for $50,000 that should be

there and is not!

Where did the $50,000 go? The possibilities are:

1. Quantities and prices may have been incorrectly stated on the inventory. In this example, the inventory has increased disproportionately to the increase in sales. Inventory turn, cost of goods sold divided by inventory, has declined from nearly 3 1/2 times to 3 times. We doubt that items were left off inventory or under priced.
2. Purchases have increased more than sales. Has our profit margin been reduced because of a large scale repeated error in pricing?
3. Purchases and sales recording may have been improper. We must recheck to see that all sales were included as recorded and that purchases are correct. Invoices for purchases may have been duplicate paid or improperly recorded. Discounts and allowances may not have been taken.
4. Merchandise may have been taken - shop lifted or stolen from supply rooms.

5. Cash from sales may have been taken by sales staff, managers, or others who might have access to cash before the bank deposit is made.

An investigation is clearly needed. A manager, noting this situation, should immediately call for professional help, and draw no conclusions or take no action until the underlying records have been thoroughly reviewed by competent professionals.

You are not concerned? Surely your auditors would notice that $50,000 is not accounted for, and begin a review at once. Don't bet on it. Auditors are conditioned to statement preparation, mathematical accuracy, and clear reporting. Management is your function.

The rest of the statement is less interesting. How do you follow an act like that? Further points to consider and further clues are present and should receive attention.

Personnel costs have gone down. Is the manager or an assistant working harder in order to work alone? Benefits have not changed. Are actual costs charged or does the college use rates that may not have been charged?

Occupancy is also charged at the same rate which may be adequate to cover costs, but may not reflect market value. A lease company may offer $50,000 to $75,000 rent for a million dollar store depending upon location and other factors. Shouldn't the college also expect at least $50,000?

Other operating costs have also been held down; perhaps, by a manager who knew profits would be impaired. We need to investigate the zero in professional services to see if a proper charge has not been paid or has been incorrectly charged.

Well, we have seen that the real bottom line is not always at the bottom. We have found stories all through the statements. Such statements are constructed to help you to manage. I hope that this presentation will make reading financial statements more interesting and more profitable for you.

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